Research:

Honolulu City & County, Hawaii; Utility, Water/Sewer

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Primary Credit Analyst(s): Ian Carroll, San Francisco (1) 415-371-5060; ian_carroll@standardandpoors.com
Secondary Credit Analyst(s): Gabriel Petek, San Francisco (1) 415-371-5042; gabriel_petek@standardandpoors.com

Credit Profile

US$134.29 mil wstwtr sys rev bnds ser 2005A due 07/01/2025 AA-
Sale date: 18-JUL-2005
US$16.45 mil wstwtr sys rev bnds ser 2005B due 07/01/2015 AA-
Sale date: 18-JUL-2005

OUTLOOK: STABLE

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to the City and County of Honolulu, Hawaii's $150.74 million series 2005A and 2005B wastewater revenue bonds, issued for the Department of Environmental Services, reflecting:

- The largely residential service area of the wastewater system, serving 71% of the population of Oahu;
- System capacity that is adequate to meet both current and projected flow;
- Financial policies that include a debt service coverage target of no less than 1.6x on senior lien debt and 1.25x on all debt; and
- Good cash reserves, supported by a plan to maintain at least three months of operating expenses in reserve.

The above strengths should enable the department to manage its large, $2.1 billion capital plan (1998-2017 and measured in 2005 dollars), which will require several large rate increases. Earlier this year, the mayor proposed and the city council adopted a multiyear rate increase that includes a 25% increase in fiscal 2006 and a 10% increase each year through fiscal 2011.

The bonds are secured by a pledge of net operating revenues of the wastewater enterprise.

The Department of Environmental Services of the City and County of Honolulu was created in 1998 as an enterprise fund to manage the wastewater system. The system serves most of the city and county, except for certain isolated areas that rely on private systems. The system serves more than 600,000 residents, or 71% of the city and county. Of the 150,000 customer accounts, 140,000 are residential, with only 6.7% from businesses and industrial customers. Though only 6.7% comes from customer accounts, these business and industrial customers account for 22% of revenues. There is not considerable customer concentration, however, with the leading 10 customers contributing less than 6% of total revenues. Average system demand is 110.8 millions of gallons per day (mgd), or about 77% of the system's capacity of 144 mgd. With relatively slow growth in the population of Oahu, projected to total 7% over the next 10 years, the system's capacity should be sufficient.

Until the recent multiyear rate increase proposed by Mayor Mufi Hannemann and adopted by the city council, the department had not increased the rates customers pay for wastewater service since 1993. Current rates of $32.61 for 7,500 gallons, with a typical monthly bill of $42.85, are moderate for similarly sized city wastewater systems. The Department of Environmental Services relies on the Honolulu

Board of Water Supply to bill for most wastewater service and water service on a single bill. Rates are to be increased substantially in support of the department's capital plan, beginning with an expected 25% increase effective in July 1, 2005. Rate increases also are expected each year after fiscal 2006, and the typical monthly residential bill is expected to grow to $66.54 by 2011.

The adopted multiyear rate increase should enable the department to meet financial targets. The department has a policy to maintain a target senior lien debt service coverage ratio of at least 1.6x, and 1.25x on all debt, regardless of lien position. Based on 2004 audited financial statements, net revenues available for debt service would have provided more than 2.17x coverage of maximum annual debt service on these series 2005 bonds and all parity debt. Net 2004 revenues covered all system debt, including junior bonds, by 1.5x. The amount of connection fee revenue included in the coverage ratios is minimal. Additionally, the planned rate increases are intended to enable the department to maintain a minimum of three months of operating expenses in reserve. In 2003, unrestricted cash and investments totaled 204 days' worth of operating expenses and this level declined somewhat in 2005 to $30.2 million, or 147 days' cash.

The department's capital plan will require additional debt financing. In addition to these series 2005 bonds, an additional $641.6 million in parity debt is expected through fiscal 2010. Other financing sources include subordinate bonds, facility charges, and net revenues. The department's capital plan involves projects required as a result of several consent decrees between the department and federal and state regulatory authorities.

Outlook

The stable outlook reflects Standard & Poor's expectation that the adopted rate increases will enable good financial performance.

Economy

The Honolulu economy is reliant on defense and tourism. The four leading employers--Pearl Harbor Naval Complex, Schofield Barracks and Fort Shafter, the Marine Corps Base Hawaii Kaneohe Bay, and Hickam Air Force Base--have a combined employment of about 64,000 personnel. Tourist-dependent employers include large hotel companies Marriott International, Hilton Hotels, and Outrigger Hotels, as well as Aloha Airlines and Hawaiian Airlines, and have a combined employment of 16,000. The job market is good in Honolulu with an unemployment rate of 3.1%, which was more favorable than the U.S. rate of 5.5% in 2004.

Wastewater System Capital Plan

The system is in its eighth year of a 20-year capital plan, which is revised and adjusted periodically. In the near-term, 2006 through 2010, the system's capital spending is anticipated at $759 million, largely financed through revenue bonds. Only about 20% of the needs of the system are growth-related, with most of the program intended to improve collection and treatments systems. Among the more urgent needs of the system is the replacement of old and corroded pipes that allow inflow and overflow during rainy seasons, a problem, which if unresolved, could lead to environmental violations. Treatment upgrades include enhancing ability to meet regulatory requirements, particularly during wet weather, in some cases to accommodate growth. An estimated $503 million will be spent on collection system improvement and $203 million on treatment, and projects are largely mandatory, rather than discretionary, in order to remain compliant with regulatory agencies and consent decrees.

Finances and Debt

The system's debt level is expected to rise as it continues its capital program. Revenue bonds secured by net system revenues on both a senior and subordinate basis are the leading financing source for capital projects. Rate increases have been preapproved through 2011 as well as management policies that set minimum cash reserve levels and debt service coverage levels. Before the issuance of these series 2005 bonds, the system had $187.025 million in senior lien revenue bonds outstanding and $482.55 million in junior lien revenue bonds outstanding. Coverage on all the system's bonds is not expected to be lower than 1.38x, according to financial projections that incorporate approved rate increases and modest system growth.